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PRESERVING PURCHASE MONEY SECURITY INTERESTS AND ALLOCATING PAYMENTS

The primary purpose of the Uniform Commercial Code (UCC) is to bring uniformity to commercial transactions.¹ Article Nine specifically seeks to serve this purpose by regularizing dealings between debtors and creditors to facilitate secured transactions.² Contrary to the intentions of its framers, the UCC has not produced uniform results. Rather, in defining creditors' rights in the context of secured transactions, courts have reached differing conclusions.

Some courts have determined that even if a creditor has a purchase money security interest (PMSI)³ in a given item, that purchase money status is destroyed when the creditor acquires a security interest in other property through either an after-acquired property clause, a future advances clause, or both.⁴ Other courts find that the purchase money status of the original item may be retained, but neither the security interest in the after-

1. U.C.C. general commentary (1978).

2. U.C.C. § 9-101 comment (1977) (noting that Article Nine is a "radical simplification in the formal requisites for creation of a security interest"); U.C.C. § 9-102 comment (1977) (reporting "[t]he main purpose of this Section is to bring all consensual security interests in personal property and fixtures under this Article"); B. CLARK, *THE LAW OF SECURED TRANSACTIONS UNDER THE UNIFORM COMMERCIAL CODE* ¶ 1.1 (1980 & Supp. 1986). See generally 1 G. GILMORE, *SECURITY INTERESTS IN PERSONAL PROPERTY* (1965).

Article Nine was drafted to facilitate commercial financing by expanding the use of personal property as collateral. Comment, *Secured Transactions—Status and Priority Between Conflicting Purchase Money Security Interests*, 15 MEM. ST. U.L. REV. 435, 438 (1985).

Additionally, ease and continuity of procedure with respect to security agreements between creditors and debtors lessen the risks inherent in loan transactions. Hansford, *The Purchase Money Security Interest in Inventory Versus the After-Acquired Property Interest—A "No Win" Situation*, 20 U. RICH. L. REV. 235, 236 (1986).

3. Purchase money security interest is defined *infra* note 5 and accompanying text.

4. Section 9-204 of the UCC permits a creditor to include both an after-acquired property clause and a future advances clause in the security agreement. An after-acquired property clause allows the creditor to take a security interest in the debtor's existing property and in property the debtor may purchase after granting the original security interest. See B. CLARK, *supra* note 2, ¶ 10.1[1]. A future advances clause provides that a creditor's security interest in collateral secures both the debt arising from the original transaction and any future indebtedness. *Id.* ¶ 10.1[3].

acquired property nor the additional debt created by a future advances clause would be purchase money secured. This lack of consensus further leads to conflicts over priority between creditors who have a security interest through an after-acquired property clause or a future advances clause and creditors who claim a PMSI.

This Note explores the rationale underlying the courts' conflicting decisions in light of the purposes of the UCC. It concludes that the language of the UCC and its goals of uniformity and simplification require that a PMSI should not be entirely destroyed because a creditor also has a security interest in items the debtor acquired after the purchase money transaction or because a creditor extends additional credit. The best solution is to permit the creditor to retain a PMSI, to the extent of the purchase money loan, in those goods that the creditor's loan helped to purchase.

Part I is a general overview of the terminology and commercial law relevant to the discussion of PMSI's. Part II examines the conflicting case law concerning whether PMSI's should be entirely destroyed when security agreements contain future advances clauses, after-acquired property clauses, or both. Part III discusses the possible methods for allocating payments between purchase money and nonpurchase money secured items and suggests that although the most effective method depends upon the context of the transaction, the first-in, first-out method of allocation is the most useful.

I. A GENERAL DISCUSSION OF PMSI'S

Article Nine, section 107 of the UCC defines the term purchase money security interest:

A security interest is a 'purchase money security interest' to the extent that it is

- (a) taken or retained by the seller of the collateral to secure all or part of its price; or
- (b) taken by a person who by making advances or incurring an obligation gives value to enable the debtor to acquire rights in or the use of collateral if such value is in fact so used.⁵

5. U.C.C. § 9-107 (1977). The debt must be limited to all or a part of the purchase price of the collateral, and the collateral must be limited to the item sold or the item for

The PMSI concept is important in the UCC scheme because it gives a creditor with a PMSI priority over other creditors who have a security interest in the same property.⁶ In general, the first security interest perfected⁷ has priority under the first-in-time, first-in-right rule.⁸ The UCC makes an exception to this rule for a PMSI.⁹ PMSI creditors have priority over all non-PMSI creditors, regardless of who perfected their security interest first.

A PMSI in inventory has priority over a conflicting security interest in the same inventory if the PMSI is perfected when the debtor receives possession of the inventory and if written notice is provided to others who have a security interest in the inventory.¹⁰ A creditor with a PMSI in property other than inventory has priority if that creditor perfects the PMSI when the debtor receives possession of the collateral or within ten days.¹¹ A PMSI in consumer goods is automatically perfected.¹²

A clearly defined rule of creditor priority is crucial to certainty and predictability in the resolution of secured transaction dis-

which the loan enabled the purchase. McLaughlin, "Add On" Clauses in Equipment Purchase Money Financing: Too Much of a Good Thing, 49 *FORDHAM L. REV.* 661, 662 (1981).

6. U.C.C. § 9-312 (1977) (setting forth rules of priority among creditors).

7. U.C.C. §§ 9-302 to -306 (1977). Perfection is a procedure under Article Nine that determines priority among secured creditors. The manner in which a creditor may perfect a security interest depends upon the subject of the security interest. Generally, a security interest becomes perfected: (1) when the creditor files a financing statement, (2) when the creditor possesses the collateral, or (3) automatically upon the creation of the security interest. An example of an automatically perfected security interest is a purchase money security interest in consumer goods. For a thorough discussion of perfection under the UCC, see J. WHITE & R. SUMMERS, *HANDBOOK OF THE LAW UNDER THE UNIFORM COMMERCIAL CODE* §§ 23-5 to -20 (2d ed. 1980).

8. U.C.C. § 9-312(5) (1977); see B. CLARK, *supra* note 2, ¶ 3.8[1]. Because the first-in-time, first-in-right rule is simple and promotes certainty, it is easily comprehended, facilitates commercial activity, minimizes the cost of doing business, and helps the debtor to obtain credit.

9. See B. CLARK, *supra* note 2, ¶ 3.9[1]; Jackson & Kronman, *Secured Financing and Priorities Among Creditors*, 88 *YALE L.J.* 1143 (1979) (providing an economic analysis of the priority of purchase money secured creditors); Note, *Preserving the Purchase Money Status of Refinanced or Commingled Purchase Money Debt*, 35 *STAN. L. REV.* 1133, 1142 (1983).

10. U.C.C. § 9-312(3) (1977); see J. WHITE & R. SUMMERS, *supra* note 7, §§ 23-4 to -5 (suggesting that UCC requires notice to a creditor with a prior security interest in debtor's inventory that another creditor now has an interest in the inventory so that the first creditor can be on guard against making further advances against new inventory); see also B. CLARK, *supra* note 2, ¶ 3.9[3][a]; Hansford, *supra* note 2, at 242.

11. U.C.C. § 9-312(4) (1977); see B. CLARK, *supra* note 2, ¶ 3.9[4][a].

12. U.C.C. § 9-302(1)(d) (1977). For reasons underlying automatic perfection of PMSI's in consumer goods, see 1 G. GILMORE, *supra* note 2, § 19.4, at 535; J. WHITE & R. SUMMERS, *supra* note 7, § 23-7.

putes.¹³ Nevertheless, the PMSI exception to the first-in-time, first-in-right rule has several justifications: (1) priority provides an incentive for creditors other than first creditors to extend credit to debtors;¹⁴ (2) priority similarly provides an incentive to first creditors to extend further credit to debtors for subsequent purchases;¹⁵ (3) priority tends to promote and facilitate sales by relieving sellers from the burden of investigating other claims on goods in which they retain a security interest;¹⁶ and (4) priority protects the debtor against being limited to acquiring credit from only the first creditor.¹⁷

The PMSI also plays an important role in determining whether a trustee in bankruptcy can avoid a debt under section 522(f) of the Bankruptcy Code.¹⁸ Although a trustee in bankruptcy may retain certain household property that is not subject to a PMSI, the Bankruptcy Code does not allow the trustee to avoid a creditor's PMSI in property such as household goods.¹⁹ Congress sought to keep creditors from forcing debtors to make payments by threatening repossession of household goods but also wanted to protect creditors who loaned funds for the purchase of household items.²⁰ The PMSI exception to the abil-

13. See generally B. CLARK, *supra* note 2, ¶ 3.1[2].

14. *Id.* ¶ 3.9[1]; Hansford, *supra* note 2, at 240-41.

15. Hansford, *supra* note 2, at 258.

16. J. WHITE & R. SUMMERS, *supra* note 7, § 25-5, at 1043; Hansford, *supra* note 2, at 242; McLaughlin, *supra* note 5, at 670.

17. J. WHITE & R. SUMMERS, *supra* note 7, § 25-5, at 1043; Hansford, *supra* note 2, at 258.

18. 11 U.S.C. § 522(f) (1982). This section of the Bankruptcy Code is part of the Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, 92 Stat. 2549 (codified at 11 U.S.C.).

19. 11 U.S.C. § 522(f) (1982). For an in-depth discussion of the rationale underlying the PMSI exception in the Bankruptcy Code, see Note, *The Transformation Rule Under Section 522 of the Bankruptcy Code of 1978*, 84 MICH. L. REV. 109 (1985) [hereinafter Note, *The Transformation Rule Under Section 522*]; Note, *Section 522(f): A Proposal for the Survival of Purchase Money Security Interests Following Refinancing*, 18 TULSA L.J. 280 (1982) [hereinafter Note, *Section 522(f)*]. See also Note, *supra* note 9, at 1140.

Specifically, Congress sought to distinguish between PMSI's and non-PMSI's to encourage purchase money lending, while permitting debtors to retain household goods that the creditor did not enable them to obtain. Note, *The Transformation Rule Under Section 522*, *supra*, at 127.

20. Congress reached the decision, permitting bankrupt debtors to avoid nonpurchase money security interests in certain household goods, by compromising between the pre-1978 Bankruptcy Code, which did not exempt any property from repossession by a secured creditor, and a desire to protect bona fide PMSI's and to provide a fresh start for the debtor. Congress provided for debtor avoidance of PMSI's in household goods because household goods are usually of negligible monetary value, provide little if any security to the creditor, and are relatively expensive for the debtor to replace, greatly limiting the debtor's fresh start if avoidance were not permitted. Note, *The Transformation Rule Under Section 522*, *supra* note 19, at 115. Thus, Congress provided legislative as-

ity of the trustee in bankruptcy to avoid security interests in household goods ensures equitable treatment of creditors within a framework that preserves those items that individual debtors need for a fresh start.²¹

II. JUDICIAL TREATMENT OF PMSI'S

The courts considering PMSI's have disagreed as to whether PMSI's should be destroyed entirely if a security agreement includes an after-acquired property clause, a future advances clause, or both. The determinative issue is whether a creditor, who originally loans money for the purchase of an item, creating a PMSI in the item, retains the PMSI in that item if the creditor also secures that loan with after-acquired property, or extends further credit secured by that item through a future advances clause, or both.²² This section focuses first upon those cases in which the courts concluded that the creditor's PMSI in an item was destroyed and then upon those cases in which the courts permitted the creditor to retain the PMSI.

A. Cases Holding That the PMSI Should Be Destroyed

Several courts have held that inclusion of either an after-acquired property clause or a future advances clause in a security agreement should entirely destroy a PMSI.²³ This is called the

surance that nonavoidable PMSI's would be limited to the scope outlined in § 522(f) of the Bankruptcy Code.

21. Note, *Avoiding Liens Under the New Bankruptcy Code: Construction and Application of Section 522(f)*, 15 U. MICH. J.L. REF. 577, 582 (1982).

The purposes underlying the avoidance of non-PMSI's in household goods are: (1) to enable a debtor to make a fresh start, (2) to preserve the debtor's assets to repay general creditors, (3) to protect debtors from the results of overcharging, and (4) to limit a debtor's opportunity to abuse the protection of the Bankruptcy Code by making an exception to the avoidance allowance where a creditor has a PMSI. Hansford, *supra* note 2, at 254-55; Note, *Section 522(f)*, *supra* note 19, at 286, 288.

22. Section 9-204(1) of the UCC permits a security agreement to include a term that obligations pursuant to the security agreement are also secured by after-acquired property. The same sort of determination is required if there is a combination of these two methods of security.

23. See *infra* notes 25-37 and accompanying text; see also *Matthews v. Transamerica Fin. Serv.* (*In re Matthews*), 724 F.2d 798 (9th Cir. 1984); *In re Harrell*, 72 Bankr. 107 (Bankr. N.D. Ala. 1987); *In re Faughn*, 69 Bankr. 18 (Bankr. E.D. Mo. 1986); *Mulcahy v. Indianapolis Morris Plan Corp.* (*In re Mulcahy*), 3 Bankr. 454 (Bankr. S.D. Ind. 1980); *Norrell v. W.S. Badcock Corp.* (*In re Norrell*), 426 F. Supp. 435 (M.D. Ga. 1977); Good-

transformation rule because inclusion of either clause transforms the security interest entirely into a non-PMSI.²⁴

The first case to hold that a PMSI should be destroyed if an item secured more than its own purchase price was *In re Simpson*.²⁵ In *Simpson*, the debtor purchased certain farm equipment from the seller, who retained a PMSI in the equipment. The security agreement between debtor and seller included a clause providing that the equipment was security not only for its own purchase price but for future indebtedness as well.²⁶ The court relied upon comment 2 to U.C.C. section 9-107 in reaching its decision.²⁷ Section 9-107 excludes a security interest in a preexisting claim or an antecedent debt from purchase money status. Failing to find any difference between preexisting claims or antecedent debts, on the one hand, and future advances, on the other hand, the *Simpson* court found that the PMSI in the farm equipment was destroyed. It expressed the view that if a creditor wanted to take advantage of the benefits of having a PMSI,²⁸ then "the burden should be on him to prepare a simple instrument which shall be a pure purchase money security agreement without attempting to burden it with complicated and ambiguous impedimenta."²⁹

*Roberts Furniture Co. v. Manuel (In re Manuel)*³⁰ advocated the approach used by the *Simpson* court. In this case, the debtor bought furniture from the creditor on one date and later purchased a television set from the creditor. The security agreement covering the television set added the unpaid balance of the fur-

year Tire & Rubber Co. v. Staley (*In re Staley*), 426 F. Supp. 437 (M.D. Ga. 1977); *In re Jackson*, 9 U.C.C. Rep. Serv. (Callaghan) 1152 (W.D. Mo. 1971).

24. *Pristas v. Landaus of Plymouth, Inc. (In re Pristas)*, 742 F.2d 797, 800 (3d Cir. 1984); Note, *The Transformation Rule Under Section 522*, *supra* note 19, at 110 n.9.

25. 4 U.C.C. Rep. Serv. (Callaghan) 243 (W.D. Mich. 1966).

26. *Id.* at 246.

27. U.C.C. § 9-107 comment 2 states:

When a purchase money interest is claimed by a secured party who is not a seller, he must of course have given present consideration. This Section therefore provides that the purchase money party must be one who gives value "by making advances or incurring an obligation": the quoted language excludes from the purchase money category any security interest taken as security for or in satisfaction of a pre-existing claim or antecedent debt.

28. In this case, the benefit arose because the farm equipment had a purchase price of less than \$2500. Thus, no filing was necessary in order to perfect under U.C.C. § 9-302(1)(c). *In re Simpson*, 4 U.C.C. Rep. Serv. at 245-46.

29. *In re Simpson*, 4 U.C.C. Rep. Serv. at 248. The determination that the PMSI was entirely destroyed because the equipment secured more than its purchase price was merely dictum because the court held that the seller had saved the security interest on other grounds. *Id.* at 249.

30. 507 F.2d 990 (5th Cir. 1975).

niture's price to the unpaid balance on the television. The agreement further stated that the goods it covered secured all present and future obligations of the debtor to the creditor. The debtor subsequently filed for bankruptcy. The court found that payments had been made on both debts without any indication of the items to which the payments were being applied and to what extent each item was being paid off.³¹ Noting that a "plain reading" of the statute indicated that a PMSI cannot exceed the price of what is purchased if the creditor wants to take advantage of one of the benefits of holding a PMSI,³² the court held that the attempt to secure the loan for the furniture with the television, which was after-acquired property, and to use the furniture to secure the subsequent advance for the television destroyed the PMSI in the furniture.³³

A recent case in which a court has held that a PMSI is destroyed is *Southtrust Bank v. Borg-Warner Acceptance Corp.*³⁴ In this case, Borg-Warner Acceptance Corp. (BWAC) purchased invoices from sellers who had supplied inventory to debtors. Both an after-acquired property clause and a future advances clause were included in the agreements that secured the inventory items. The bank, however, also had a security interest in the debtors' inventories, which it had perfected by filing prior to BWAC.³⁵ Relying on *Simpson* and *Manuel*, the court held that BWAC's use of the after-acquired property clause and future advances clause in its security agreements with the debtors destroyed its PMSI in debtors' inventories. The court refused to distinguish between consumer and commercial transactions or between bankruptcy and nonbankruptcy situations because nothing in the language of U.C.C. section 9-312 or section 9-107 makes this distinction.³⁶ Furthermore, the court stated, "Unless a lender contractually provides some method for determining

31. *Id.* at 993.

32. In this case, the benefit would be that no filing is required in order to perfect a PMSI in consumer goods under U.C.C. § 9-302(1)(d).

33. The court did not determine whether the PMSI in the television was destroyed. *In re Manuel*, 507 F.2d at 994.

34. 760 F.2d 1240, *reh'g denied*, 774 F.2d 1179 (11th Cir. 1985).

35. Thus, both BWAC and the bank had perfected security interests in the debtors' inventories. The issue was whether the after-acquired property clause and future advances clause in BWAC's security agreement destroyed BWAC's PMSI, making BWAC's interest in the debtors' inventories subordinate to the bank's interest. *Id.* at 1242.

36. *Id.* The court, therefore, extended the *Manuel* holding—that a PMSI cannot extend beyond the price of the item purchased when the security interest was created—to BWAC's security interest.

the extent to which each item of collateral secures its purchase money, it effectively gives up its purchase money status."³⁷

In sum, the courts holding that the inclusion of an after-acquired property clause, a future advances clause, or both in a security agreement destroys the creditor's PMSI have followed a distinct line of reasoning. First, a security interest in after-acquired property or for future advances is the same as a security interest in a preexisting claim or an antecedent debt. Section 9-107 of the UCC does not include such security interests in the category of PMSI's, so any security interest acquired in after-acquired property or for future advances cannot be a PMSI. Second, because the creditor benefits from having a PMSI, he should be limited to writing a security agreement that provides only for a PMSI in the collateral purchased for the amount of the purchase price, in compliance with the language of section 9-107. Finally, failure to include in the security agreement a method that indicates the extent to which each item of collateral secures its purchase price destroys the creditor's PMSI because there is no way to determine the portion of the debt that is purchase money secured.

B. Cases in Which the PMSI Has Not Been Entirely Destroyed

Other courts have taken the position that a PMSI should not be entirely destroyed merely because the security agreement permits the purchase money collateral to secure future advances or because items purchased after the security agreement takes effect are additional security for the original collateral, or both. Instead, these courts have held that purchase money status should be preserved to the extent that the collateral secures its own purchase price.³⁸

One early case taking this approach was *In re Gibson*,³⁹ in which a bankrupt debtor sought to avoid a creditor's security interest. The creditor had loaned funds to the debtor for the purchase of consumer goods under the terms of a security agree-

37. *Id.* at 1243.

38. See *infra* notes 39-63 and accompanying text; see also *In re Moore*, 33 Bankr. 72 (Bankr. D. Or. 1983); *Russell v. Associates Fin. Serv. Co.* (*In re Russell*), 29 Bankr. 270 (Bankr. W.D. Okla. 1983); *Associates Fin. v. Conn* (*In re Conn*), 16 Bankr. 454 (Bankr. W.D. Ky. 1982); *Slay v. Pioneer Credit Co.* (*In re Slay*), 8 Bankr. 355 (Bankr. E.D. Tenn. 1980).

39. 16 Bankr. 257 (Bankr. D. Kan. 1981).

ment that included a future advances clause and an after-acquired property clause. The court reasoned, first, that if the PMSI were destroyed, a creditor who did not file a financing statement, relying on the automatic perfection of a PMSI in consumer goods, would no longer be perfected. Second, even if the PMSI were not automatically perfected, and the creditor did not lose perfection, the creditor whose PMSI was destroyed still could lose priority over prior perfected secured creditors, and the purposes of priority would be defeated. Third, destruction of the PMSI would discourage further extension of credit, thus discouraging sales. Finally, the bankrupt debtor could avoid a creditor's security interest if the creditor lost purchase money status, although the purpose of section 522(f) of the Bankruptcy Code was to permit avoidance of security interests only in already owned consumer goods, not in goods that were purchased with money loaned by the creditor.⁴⁰

The *Gibson* court found these four considerations sufficiently problematic to reject use of the transformation rule. Instead it held that a secured debt could be split into two parts: a purchase money part, consisting of the amount of the debt that represented the purchase price of the collateral; and a nonpurchase money part, consisting of the remainder of the debt.⁴¹ This definition of PMSI's would support the purposes of a uniform system of priorities; would encourage further advancement of credit, thus encouraging sales; and would disallow a bankrupt debtor from improperly avoiding a purchase money creditor's security interest.⁴² The court chose a first-in, first-out (FIFO) method for determining the security interests in collateral because of its use in the Uniform Consumer Credit Code (UCCC) and in case law.⁴³

40. 11 U.S.C. § 522(f) (1982); *In re Gibson*, 16 Bankr. at 265-66.

41. *In re Gibson*, 16 Bankr. at 267-68.

42. *Id.* at 266.

43. NATIONAL CONFERENCE OF COMM'RS ON UNIFORM LAWS, UNIFORM CONSUMER CREDIT CODE § 2-408(1) (1968) [hereinafter U.C.C.C.]; *In re Gibson*, 16 Bankr. at 268; accord *Coomer v. Barclays Am. Fin., Inc. (In re Coomer)*, 8 Bankr. 351 (Bankr. E.D. Tenn. 1980) (noting that without a method of apportioning a loan between purchase and nonpurchase money parts and a method of applying the payments to the parts, the seller's purchase money security interest in an item must be lost); *Goodyear Tire & Rubber Co. v. Staley (In re Staley)*, 426 F. Supp. 437 (M.D. Ga. 1977) (holding that if the seller retains a security interest in consumer goods purchased by the debtor under a security agreement that includes both an after-acquired property clause and a provision that items first purchased shall be deemed first paid for, the PMSI is not destroyed because the security agreement explicitly stated that the seller's security interest in each item terminated as soon as the purchase price of the item was paid).

*Kawasho International (U.S.A.), Inc. v. Alper (In re Mid-Atlantic Flange)*⁴⁴ dealt with a security agreement between a seller and a debtor that included a clause extending to goods sold in the future and to future indebtedness. A bank also had a security agreement with the debtor that covered after-acquired property and had been perfected prior to the seller's security interest. The bank argued that the seller's interest, although originally a PMSI, should no longer be a PMSI because of the terms of the security agreement.⁴⁵ The court distinguished *Simpson*⁴⁶ and *Manuel*,⁴⁷ among other cases, by noting that first, the seller and debtor never exercised the future advances or the after-acquired property clause, and second, that this was a commercial, rather than a consumer transaction, and therefore less concern was required for protection of the debtor. Thus, the court held that the mere presence of an after-acquired property clause and a future advances clause in a security agreement did not destroy the purchase money status of the seller's security interest.⁴⁸

Similarly, *Pristas v. Landaus of Plymouth, Inc. (In re Pristas)* held that a PMSI should not be destroyed to the extent it represented the purchase price of the collateral.⁴⁹ In this case, a bankrupt debtor attempted to avoid a creditor's security interest by asserting that the creditor's PMSI in consumer items was destroyed as the result of a future advances clause and an after-acquired property clause in the security agreement. The debtor originally purchased a washing machine from the creditor, and before fully paying for the washer, bought a recliner from the same creditor.⁵⁰ Although the security agreement included no formula for payment allocation, the bankruptcy judge determined that the common law provided a method of apportioning the debtor's payments between the two items,⁵¹ and thus, the creditor's PMSI could be saved to the extent that each item se-

44. 26 U.C.C. Rep. Serv. 203 (Bankr. E.D. Pa. 1979).

45. *Id.* at 205-06.

46. *See supra* notes 25-29 and accompanying text.

47. *See supra* notes 30-33 and accompanying text.

48. *In re Mid-Atlantic Flange*, 26 U.C.C. Rep. Serv. at 209. The court also suggested that the decision in *Simpson*, dealing with a financier under U.C.C. § 9-107(b), should not be applied to sellers under U.C.C. § 9-107(a) because the reasoning applied there relied on U.C.C. § 9-107 comment 2, which applies only to financiers. *In re Mid-Atlantic Flange*, 26 U.C.C. Rep. Serv. at 208-09.

49. 742 F.2d 797 (3d Cir. 1984).

50. *Id.* at 799.

51. The common law method of apportionment provided that, absent a designation by the debtor, the creditor could apply payments as the creditor wished or in a manner most beneficial to the creditor, i.e., to the debt least secured. *Id.* at 800 (quoting *Page v. Wilson*, 150 Pa. Super. 427, 433, 28 A.2d 706, 709 (1942)).

cured its own purchase price. The *Pristas* court rejected the transformation rule,⁵² and instead accepted the dual status rule.⁵³ It based its decision on the "to the extent" language of U.C.C. section 9-107, the purposes of PMSI's, and the desire to simplify transactions between the same buyer and seller.⁵⁴ The court went on to discuss the necessity of determining "the extent to which a particular item continues to secure its own price and the extent to which payment of other purchases is affected."⁵⁵ Theoretically, methods of allocation could be found in the security agreement itself, state law, or by judicial determination. Finding no allocation method in the security agreement, the court applied Pennsylvania's Goods and Services Installment Sales Act, which established allocation of payments in the same proportion or ratio as the original cash sales prices of the purchases bore to one another.⁵⁶ The court upheld the bankruptcy judge's decision that the creditor's PMSI was not destroyed and that the debtor could not avoid the creditor's security interest in the items, but applied the allocative method set forth in the Pennsylvania Act rather than the common law method.⁵⁷

A recent case retaining a PMSI is *John Deere Co. v. Production Credit Association*,⁵⁸ in which two creditors claimed priority of interest in a debtor's farm equipment. Production Credit Association (PCA) acquired a security interest in the debtor's farm equipment, which extended to after-acquired property and to future advances. PCA then loaned the debtor part of the funds required to purchase a combine, but PCA did not file a new financing statement.⁵⁹ The seller, who retained a security interest in the combine for a portion of the purchase price, as-

52. *Id.* at 801. The transformation rule states that a PMSI is transformed into a non-PMSI by the presence or exercise of an after-acquired property clause, a future advances clause, or both, in a security agreement. *See supra* note 24 and accompanying text.

53. *In re Pristas*, 742 F.2d at 801. The dual status rule provides that a PMSI in an item remains a PMSI to the extent that it secures the purchase price of that item, even if the item also secures other debt or other items secure its debt.

54. *Id.*

55. *Id.*

56. *Id.* at 802; Pennsylvania Goods and Services Installment Sales Act, PA. STAT. ANN. tit. 69, § 1802 (Purdon Supp. 1987). The court found that the bankruptcy judge erred in applying the common law rather than statutory law because the statutory treatment superseded the treatment provided in the case law. *In re Pristas*, 742 F.2d at 801.

57. *In re Pristas*, 742 F.2d at 802; accord *In re Brouse*, 6 U.C.C. Rep. Serv. (Callaghan) 471 (W.D. Mich. 1969).

58. 686 S.W.2d 904 (Tenn. Ct. App. 1984).

59. PCA provided debtor with a check that noted on its face that it was to be used for down payment on a combine. *Id.* at 905.

signed the security interest to John Deere.⁶⁰ The court determined that PCA's subsequent loan to the debtor was used as part of the purchase price of the combine and that its financing statement was sufficient to give notice to other creditors that PCA claimed an interest in all of debtor's farm equipment.⁶¹ PCA, therefore, retained a PMSI in the combine for the amount that it loaned to the debtor in order to enable the debtor to purchase the combine, and because PCA had filed its financing statement first, PCA had priority over John Deere for that amount. The court distinguished this case from cases holding that a PMSI was destroyed on the basis that this case was commercial, and therefore required less concern for protection of the debtor than those cases concerning consumer goods in a personal bankruptcy context.⁶² The court noted that because PCA had given the debtor a check, which was applied directly to the purchase of the combine, and because no payment had yet been made, there would be no difficulty in determining the extent to which PCA's security interest in the combine was purchase money.⁶³

In sum, the courts that have preserved a PMSI to the extent of the purchase price of the collateral have relied upon the following considerations. First, the "to the extent" language of U.C.C. section 9-107 requires the preservation of purchase money status for the portion of the debt that represents the purchase price of the collateral. Second, a creditor who complies with the requirements necessary to obtain a PMSI is entitled to rely on receiving the benefits of a PMSI. Third, preserving the PMSI fulfills the purposes of the UCC: certainty, predictability, and facilitation of secured transactions. Fourth, the Bankruptcy Code's intended purpose was only to permit avoidance of security interests in consumer goods that the debtor owned before the creditor provided the loan, not the security interest in goods purchased with the loan. Recognizing the PMSI to the extent of the purchase price complies with that limited purpose. Last, in commercial, as opposed to consumer transactions, the debtor does not require as much protection from the creditor.

60. The debtor had signed a security agreement and financing statement that was filed after PCA's financing statement. *Id.*

61. PCA's financing statement, which described farm equipment and extended to after-acquired property, was sufficient to alert John Deere to PCA's interest in the combine. *Id.* at 906.

62. *Id.* at 906-07.

63. *Id.* at 907.

C. Retention of a PMSI to the Extent of the Purchase Price

Consideration of the language and purposes of the UCC leads one to conclude that a PMSI should be retained to the extent the collateral secures the purchase price of an item, leaving the remainder of the debt as nonpurchase money.⁶⁴ First, the specific language of the UCC provision defining PMSI's provides that a security interest is purchase money "to the extent" that the item secures all or part of its price.⁶⁵ The cases permitting retention of PMSI's recognize the "to the extent" language,⁶⁶ whereas those courts that have held that a PMSI must be entirely destroyed by inclusion of a future advances clause, an after-acquired property clause, or both, give no meaning to that particular wording. Instead, they interpret the provision as if the statute read: "A security interest is a purchase money security interest *if* it is taken or retained . . . to secure all or a part of its price." The basic premise of statutory construction that each word should be given meaning requires that courts retain PMSI's up to the amount of the purchase price of the secured item.⁶⁷ In addition, recognizing a PMSI to the extent that the item secures its purchase price does not contradict comment 2 to U.C.C. section 9-107, which excludes from purchase money status a security interest taken in satisfaction of a preexisting claim or antecedent debt. Consistent with comment 2, the security interest in an item will be a non-PMSI to the extent that a security agreement provides that the item will secure an existing debt through an after-acquired property clause and that the item will secure future debt through a future advances clause.⁶⁸

Second, retention of a PMSI will fulfill the purposes underlying the UCC priority rules. To the extent that a creditor provides money to a debtor to enable a purchase, the creditor will be the first party entitled to payment or return of the collateral should the debtor default on the debt. This provides incentive

64. See *supra* notes 1-2 and accompanying text.

65. U.C.C. § 9-107 (1977).

66. See *supra* notes 38-63 and accompanying text.

67. *Associates Fin. v. Conn (In re Conn)*, 16 Bankr. 454, 457 (Bankr. W.D. Ky. 1982); *Coomer v. Barclays Am. Fin., Inc. (In re Coomer)*, 8 Bankr. 351, 353 (Bankr. E.D. Tenn. 1980); *Slay v. Pioneer Credit Co. (In re Slay)*, 8 Bankr. 355, 357 (Bankr. E.D. Tenn. 1980); *McLaughlin, supra* note 5, at 694; Note, *supra* note 9, at 1158; Note, *Section 522(f)*, *supra* note 19, at 301 (the language of the UCC limits but does not void the availability of purchase money status).

68. One writer suggests that the "to the extent" language of U.C.C. § 9-107 was included to limit purchase money status, but not to void purchase money status entirely. Note, *Section 522(f)*, *supra* note 19, at 301; see also Note, *supra* note 9, at 1157.

both for the creditor to continue to loan money to a debtor for purchases, without the worry that adding debt to already existing debt will rob her of priority, and for a new creditor to loan money to a debtor, without the worry that an earlier creditor will have priority with respect to the item for which the new creditor provided the loan.⁶⁹ Additionally, relieving creditors from investigating other potential claims would simplify and facilitate sales.⁷⁰ This solution properly ensures that the creditor who enables the purchase will be entitled to the return of the collateral if the debtor defaults.⁷¹

Third, recognizing a PMSI to the extent that the item secures its own purchase price also furthers the policies underlying the Bankruptcy Code.⁷² A debtor should not be entitled to avoid the portion of the debt that represents the amount a creditor loaned to enable the purchase of a given item.⁷³ To the extent that an item secures a debt other than its own purchase price, however, the goals of enabling a debtor to make a fresh start, preserving a debtor's assets for general creditors, and protecting a debtor from overcharging suggest that the debtor should be entitled to avoid the nonpurchase money debt.

Many of the courts have considered the context of the transaction in deciding whether or not to destroy a PMSI and in distinguishing their decisions from cases that contradict their posi-

69. Note, *The Transformation Rule Under Section 522*, *supra* note 19, at 129. Under this procedure, the continued recognition of PMSI's would allow for continued commercial expansion. See U.C.C. § 1-102(2)(b) (1978); Note, *Section 522(f)*, *supra* note 19, at 302.

70. Note, *Section 522(f)*, *supra* note 19, at 302.

71. The reasoning that supports the retention of a PMSI is equally sound in the circumstance in which there are two purchase money secured creditors. The dilemma then becomes how to establish priority between the two creditors. In a situation in which a financing company and a dealer have competing PMSI's, it is unfair to the dealer and inconsistent with the purposes of Article Nine for a previously filed financing statement to give the financing company priority. Comment, *supra* note 2, at 448. As purchase money secured creditors, both the dealer and the financing company are entitled to that portion of the purchase price of the collateral that each provided. The problem arises when the debtor defaults and the proceeds from the sale of the collateral fall short of the total purchase price of the item. The UCC does not specifically provide a method for determining priority between two creditors who have PMSI's in the same collateral. Although authorities disagree, it seems that the general priority rule should take effect, giving priority to the first creditor to file a financing statement. J. WHITE & R. SUMMERS, *supra* note 7, § 25-5, at 1051. For purposes of this Note, however, the important point is that a PMSI should be retained even if the result is conflicting PMSI's among creditors, which then cause difficulties in determining priority.

72. The bankruptcy rules and the provisions of the UCC should complement one another. *In re Gibson*, 16 Bankr. 257, 267 (Bankr. D. Kan. 1981).

73. *Coomer v. Barclays Am. Fin., Inc.* (*In re Coomer*), 8 Bankr. 351, 354 (Bankr. E.D. Tenn. 1980); Hansford, *supra* note 2, at 253-54; Note, *Section 522(f)*, *supra* note 19, at 301.

tions. Recognition of a security interest as purchase money to the extent the item secures its own purchase price and as non-purchase money to the extent the item secures other indebtedness fulfills the goals and purposes of the UCC and the Bankruptcy Code regardless of the transaction's context. Whether a transaction occurs in a commercial or consumer setting, in a bankruptcy or nonbankruptcy situation, and whether the goods are inventory or noninventory, limited recognition of PMSI's fulfills many of the same purposes of PMSI's and of priorities and should be consistently applied to provide for uniform treatment of transactions.⁷⁴ Retention of a PMSI to the extent of an item's purchase price is also consistent with the policies behind the Bankruptcy Code,⁷⁵ inventory sales,⁷⁶ and consumer transactions.⁷⁷ The language of U.C.C. section 9-107, which fails to differentiate among the transaction contexts in defining PMSI's, further supports uniform application of the retention of a PMSI.⁷⁸

74. Note, *The Transformation Rule Under Section 522*, *supra* note 19, at 124 (promote uniformity by interpreting UCC provisions the same in bankruptcy and non-bankruptcy contexts); Note, *Section 522(f)*, *supra* note 19, at 303-04 (advantages of uniformity are ability of creditors and debtors to better determine their rights under security agreements, higher likelihood of settlement, prevention of forum shopping, consistency with general business practices). *Contra* Hansford, *supra* note 2, at 261 (noting that U.C.C. § 9-312 treats PMSI's differently depending on whether the collateral is inventory).

75. Hansford, *supra* note 2, at 246, 250, 252; Note, *The Transformation Rule Under Section 522*, *supra* note 19, at 112, 114; Note, *Section 522(f)*, *supra* note 19, at 286.

76. Hansford, *supra* note 2, at 259.

77. *Southtrust Bank v. Borg-Warner Acceptance Corp.*, 760 F.2d 1240, 1242 (11th Cir. 1985). *Contra* U.C.C., *supra* note 43, § 2-408(1); Hansford, *supra* note 2, at 261.

78. *Southtrust Bank*, 760 F.2d at 1242. The UCC differentiates between consumer and commercial goods when determining how a PMSI is perfected. The UCC provides for automatic perfection of consumer goods, as opposed to perfection by filing or possession for commercial goods, partly because that was the accepted practice before the UCC came into existence and partly because the cost of compliance with the filing requirement is too great in comparison to the small amount of a typical consumer credit transaction. See J. WHITE & R. SUMMERS, *supra* note 7, § 23-7, at 920. There are no corresponding reasons to differentiate between consumer and commercial goods in deciding whether a security interest is a PMSI under U.C.C. § 9-107. The costs and benefits of having a PMSI in consumer goods and in commercial goods both depend upon the extent to which the creditor gives the debtor funds in order to enable the debtor to purchase goods, and priority is equally useful in consumer and commercial settings.

III. METHODS OF ALLOCATING PAYMENTS BETWEEN PMSI AND NON-PMSI PORTIONS OF THE DEBT

Once it is established that a PMSI should not be entirely destroyed as the result of inclusion of an after-acquired property clause, a future advances clause, or both, in a security agreement, but instead should be retained to the extent of the purchase price of the secured item,⁷⁹ the issue becomes how to allocate payments between the purchase money and the nonpurchase money portions of the debt.⁸⁰ For the most part, the case law and scholarly writing have applied a method of apportionment without considering the costs and benefits of choosing one method over another.⁸¹ Because the cases that have held that a PMSI should be retained in part rely on the "to the extent" language of U.C.C. section 9-107, the courts and parties to the transactions should be concerned with how to determine the extent to which a PMSI is retained. Even some of the cases in which the court transformed the PMSI entirely into a non-PMSI because of the inclusion of an after-acquired property clause, a future advances clause, or both in the security agreement, indicated that one of the reasons for destroying the PMSI was that the security agreement contained no procedure for applying payments.⁸² The three alternative methods for allocating payments are separate security agreements, pro rata apportionment, and the first-in, first-out method.

79. The manner in which a PMSI should be traced when a debt represents both a PMSI and a non-PMSI is beyond the scope of this Note. For a discussion of characteristics relevant to determining how to trace the purchase money portion of a debt, see Note, *supra* note 9, at 1173-74.

80. Hansford, *supra* note 2, at 263 (stating that the purchase money secured party bears the risk that the debtor's accounting records are sufficient); McLaughlin, *supra* note 5, at 680-81 (placing the burden of proving the allocation on the creditor); Note, *supra* note 9, at 1143 (noting that the court must allocate burdens of proof).

81. *In re Gibson*, 16 Bankr. 257 (Bankr. D. Kan. 1981); Goodyear Tire & Rubber Co. v. Staley (*In re Staley*), 426 F. Supp. 437 (M.D. Ga. 1977); *In re Brouse*, 6 U.C.C. Rep. Serv. (Callaghan) 471 (W.D. Mich. 1969).

82. *Southtrust Bank v. Borg-Warner Acceptance Corp.*, 760 F.2d 1240, 1243 (11th Cir. 1985); *Roberts Furniture Co. v. Manuel (In re Manuel)*, 507 F.2d 990, 993 (5th Cir. 1975); *Coomer v. Barclays Am. Fin., Inc. (In re Coomer)*, 8 Bankr. 351, 355 (Bankr. E.D. Tenn. 1980).

A. *Separate Security Agreements*

One method for determining the application of payments to a part purchase money and part nonpurchase money debt would be to require that the creditor use two separate security agreements to obtain a security interest in a given item: one for the purchase money interest, and one for the nonpurchase money interest.⁸³ For example, suppose a creditor and a debtor execute a security agreement containing a future advances clause when the debtor purchased item A, costing \$100, from the creditor. Later, the debtor borrows \$200 from the creditor. The creditor could provide one security agreement, covering only purchase money secured debt (the \$100 loan for the purchase of item A), and a second security agreement, covering nonpurchase money secured debt (the \$200 loan). Although this sort of system would clearly differentiate purchase money from nonpurchase money interests, it is impractical. This method would contradict the goal of facilitating transactions among creditors and debtors because it requires two separate security agreements for each item purchased, leading to increased transaction costs, particularly in high turnover inventory settings. In addition to being inefficient, this method ignores the reasons stated in the UCC for recognizing after-acquired property clauses.⁸⁴ Article Nine, section 204(1), allowing a security interest in after-acquired property, permits debtor and creditor to eliminate additional transaction costs associated with making multiple security agreements to cover future transactions, as well as generally minimizing the risks of a credit transaction.⁸⁵

B. *Pro Rata Apportionment of Payments*

A second method of allocation is the pro rata apportionment of payments according to the purchase price of each item as a percentage of the entire debt. Two courts have followed this approach. The court in *Pristas*⁸⁶ relied upon the Pennsylvania Goods and Services Installment Sales Act. The Act established that payments were to be allocated in the same proportion or

83. See, e.g., NATIONAL CONSUMER LAW CENTER, NATIONAL CONSUMER ACT § 2.417 (1970); McLaughlin, *supra* note 5, at 682.

84. U.C.C. § 9-204 (1977).

85. See Jackson & Kronman, *supra* note 9, at 1166-67.

86. *Pristas v. Landaus of Plymouth, Inc. (In re Pristas)*, 742 F.2d 797 (3d Cir. 1984).

ratio as the original cash sales price of the purchases bore to one another.⁸⁷ The court in *In re Brouse*⁸⁸ based its determination of the applicable method of allocation on the method set forth in the Michigan Retail Installment Sales Act. The Act stated that payments were to be allocated to the debt in the same ratio as the original cash sales prices of each purchase bore to the total of all sales.⁸⁹

Two examples clarify how this allocative method would work. First, suppose a creditor extends credit to a debtor sufficient to enable the purchase of item A, which costs \$100. The security agreement covering this transaction contains a future advances clause. Subsequently, the creditor loans the debtor \$300. The loan is secured by item A as the result of the future advances clause. At this point, the creditor's interest in item A is:

	<u>item A</u>
PMSI	100
non-PMSI	300

The total debt is \$400. If the debtor makes a payment of \$200, under the pro rata method of allocation, the creditor would apply the payment to each debt in the proportion that that debt bears to the total debt. The debt with respect to item A is one-fourth of the total debt, so \$50 ($\frac{1}{4}$ of \$200) of the payment would be applied to the amount owed on item A. Similarly, the debt with respect to the loan is three-fourths of the total debt, so \$150 ($\frac{3}{4}$ of \$200) of the payment would be applied to the loan. After the payment, the creditor's interest is:

	<u>item A</u>
PMSI	100 - 50 = 50
non-PMSI	300 - 150 = 150

The total debt is now \$200.

In a second example, suppose a creditor sells item A to a debtor for \$100. One month later, the creditor sells item B to the

87. *Id.* at 802.

88. 6 U.C.C. Rep. Serv. (Callaghan) 471 (W.D. Mich. 1969).

89. *Id.* at 474.

debtor for \$300. Both transactions are covered by a security agreement including both a future advances clause and an after-acquired property clause. The interest that the creditor holds in items *A* and *B* is:

	<u>item A</u>	<u>item B</u>
PMSI	100	300
non-PMSI	300	100

The total debt is \$400. If the debtor were to make a payment of \$100, then under the pro rata method of allocation, $\frac{1}{4}$ of the payment would be applied to item *A*, and $\frac{3}{4}$ of the payment would be applied to item *B*. Thus, the creditor's interest in items *A* and *B* would now be:

	<u>item A</u>	<u>item B</u>
PMSI	75 (100 - 25)	225 (300 - 75)
non-PMSI	225 (300 - 75)	75 (100 - 25)

The total debt is \$300. This process would continue until one or both of the items has been paid in full.

Pro rata allocation keeps the purchase money debt separate from the nonpurchase money debt so that the extent of a creditor's PMSI in a given item is easily calculated. Also, payments are allocated so that most of the payment goes to the item on which there is the largest debt. This allocation method is favorable to the debtor because it steadily decreases the creditor's PMSI in all of the items when the creditor has a PMSI in more than one item of debtor's collateral. As a result, the creditor's priority of interest in those items is limited. Pro rata allocation of payments also fulfills the purposes of the priority exception for PMSI's by allowing the creditor to retain priority to the extent that she provided funds to enable the purchase, thus giving the creditor incentive to extend loans to enable sales. Use of this method is embraced by several state retail installment sales statutes.⁹⁰

90. ILL. ANN. STAT. ch. 121 $\frac{1}{2}$, § 522 (Smith-Hurd Supp. 1987); Michigan Retail Installment Sales Act, MICH. COMP. LAWS § 445.861(c) (1979); Pennsylvania Goods and Ser-

The pro rata allocation method may, however, cause problems in consumer goods transactions. Some courts have held that pro rata allocation of payments is unconscionable because the creditor maintains an interest in all items purchased on credit until every item's purchase price has been fully paid.⁹¹

Although the pro rata method of allocation is probably acceptable in an inventory setting,⁹² it is not very useful. When an item of inventory in which a creditor has a PMSI is sold, then the creditor has a PMSI in the proceeds of the sale. If the PMSI in the proceeds is not destroyed to the extent it represents the purchase price of the inventory item that produced the proceeds, then the creditor has priority in those proceeds for that amount. The creditor's priority does not extend, however, to the excess of the proceeds over the amount of the creditor's PMSI in the proceeds. For instance, if a creditor had a \$50 PMSI in item A of a debtor's inventory, and item A were sold for \$75, then the creditor would have priority to the extent of \$50 in the \$75 proceeds. The difficulty comes in knowing whether the proceeds came from the purchase money portion of the collateral or the nonpurchase money portion of the collateral. In most circumstances, the costs of tracing the proceeds would probably outweigh the benefit of having a PMSI in those proceeds. Thus, the advantage to a creditor of having a PMSI is very limited in an inventory setting.

C. *First-In, First-Out (FIFO) Method of Allocation*

The final method that several courts have adopted to allocate payments to purchase money and nonpurchase money debt is the first-in, first-out (FIFO) method. The *Gibson* court applied the FIFO method for allocation of payments because of its use in the Uniform Consumer Credit Code.⁹³ Several other courts, which have held that a PMSI should be retained to the extent that an item secures its own purchase price, have also chosen the FIFO method for allocating debtor's payments to creditor's se-

vices Installment Sales Act, PA. STAT. ANN. tit. 69, § 1802 (Purdon Supp. 1987); TEX. REV. CIV. STAT. ANN. art. 5069-6.02(14)(c) (Vernon 1987).

91. *Williams v. Walker-Thomas Furniture Co.*, 350 F.2d 445 (D.C. Cir. 1965); 1 J. FONSECA, HANDLING CONSUMER CREDIT CASES § 11, at 32 (3d ed. 1986).

92. See, e.g., *In re United Thrift Stores, Inc.*, 242 F. Supp. 714 (D.N.J. 1965), *aff'd sub nom. Redisco, Inc. v. United Thrift Stores, Inc.*, 363 F.2d 11 (3d Cir. 1966) (permitting the pro rata method of allocation to be applied in an inventory setting).

93. *In re Gibson*, 16 Bankr. 257, 269 (Bankr. D. Kan. 1981) (relying on U.C.C.C., *supra* note 43, § 2.409).

curity interest.⁹⁴ Several examples illustrate how the FIFO method of payment allocation works.

First, suppose that a creditor extends a debtor credit for the purchase of item A, which costs \$100 and is covered by a security agreement with a future advances clause. Later, the creditor extends the debtor further credit in a \$300 loan, secured by item A through the future advances clause. The creditor's interest is:

	<u>item A</u>
PMSI	100
non-PMSI	300

The total debt is \$400. If the debtor makes a payment of \$100, under the FIFO method, the entire payment would be applied to the debt owed on item A's purchase price. After the payment, the creditor's interest is:

	<u>item A</u>
PMSI	0 (100 - 100)
non-PMSI	300 (300 - 0)

The total debt is \$300. Because the entire PMSI in item A has been paid, the creditor no longer has priority in item A resulting from her status as a purchase money secured creditor.

In a second example, suppose a creditor sells item A to a debtor for \$100, and a month later, she sells item B to the debtor for \$300. Both loans are covered by a security agreement including an after-acquired property clause and a future advances clause. Before any payments have been made, the creditor's interest in items A and B is:

	<u>item A</u>	<u>item B</u>
PMSI	100	300
non-PMSI	300	100

94. See *Goodyear Tire & Rubber Co. v. Staley* (*In re Staley*), 426 F. Supp. 437 (M.D. Ga. 1977); *Kawasho Int'l (U.S.A.), Inc. v. Alper* (*In re Mid-Atlantic Flange*), 26 U.C.C. Rep. Serv. 203 (Bankr. E.D. Pa. 1979).

The total debt is \$400. If the debtor makes a payment of \$100, then according to the FIFO method of allocation, the entire \$100 payment would go to pay for item A. Thus, the creditor's interest in items A and B after the payment would be:

	<u>item A</u>	<u>item B</u>
PMSI	0 (100 - 100)	300
non-PMSI	300	0 (100 - 100)

The total debt is \$300. All future payments would be allocated to the amount due on item B, and the creditor would no longer have a purchase money priority in item A.

This allocative method, like the pro rata method, successfully separates the purchase money debt from the nonpurchase money debt to establish the extent to which the creditor's loan enabled debtor's purchases. Payment allocation is such that all payments go to the oldest debt until it has been fully paid. When the entire PMSI in an item is extinguished, the creditor may no longer maintain priority of interest in that item. FIFO favors the debtor in that once the debtor makes payments sufficient to pay off the purchase price of the first item bought, he is free from the creditor's priority interest in that item. This would be especially important if the debtor were bankrupt and could avoid the lien of a nonpurchase money secured creditor.⁹⁵ The FIFO method fulfills the purposes behind the UCC and also provides an incentive for creditors to loan money for purchases and to continue already existing debtor-creditor relationships, both of which facilitate sales.

The FIFO method, unlike the pro rata method, is not unconscionable in a consumer context.⁹⁶ Rather than permitting the creditor to retain a partial PMSI in all items for which the creditor has loaned the debtor the purchase price, use of FIFO permits the debtor to apply all payments to the item first purchased and to extinguish the PMSI in that item before payments are made on any other item. This method frees the debtor from the creditor's PMSI in individual items more quickly than does allocation of the same payments under a pro

95. 11 U.S.C. § 522(f) (1982).

96. J. WHITE & R. SUMMERS, *supra* note 7, § 23-7, at 923.

rata method.⁹⁷ Use of the FIFO method would mean quicker extinguishment of creditor's priority over other creditors, or over the debtor in bankruptcy, effectively limiting the use of a PMSI to the extent to which the debt corresponds to the purchase price of a given item.

Once again, difficulties arise in the usefulness of allocation in the case of inventory sales.⁹⁸ The problem involves tracing proceeds from the sale of inventory items in order to determine whether the creditor has a PMSI and, therefore, priority. The FIFO method could be used in inventory situations so that payments are applied first to pay the debt on the inventory items or proceeds in inventory items that were first purchased by the debtor holding the inventory. The FIFO method does not, however, solve the problem of tracing a creditor's PMSI in inventory to the proceeds of that inventory.

CONCLUSION

The language of the relevant provisions in the UCC, the underlying purposes of Article Nine and of the Bankruptcy Code, and the best interests of debtors and creditors compel the conclusion that inclusion of an after-acquired property clause, a future advances clause, or both in a security agreement should not destroy a PMSI entirely. Instead, a creditor's PMSI should be preserved to the extent that the credit extended was used by the debtor to purchase the item in which the creditor claims a security interest.

When considering how to allocate payments, rather than when deciding whether a PMSI should be destroyed, courts should carefully consider the context of the transaction to determine the most appropriate method of allocation. Creditors and debtors can facilitate the process by providing a workable allocation method in their security agreements. If the parties do not include an allocation method in their security agreement, then a court should use the applicable statute setting forth a method of

97. In the pro rata example, *supra* notes 88-89 and accompanying text, after debtor makes a \$100 payment, creditor still has a PMSI in both items A and B. On the other hand, in the FIFO example, *supra* notes 93-94 and accompanying text, creditor only has a PMSI in item B, since the PMSI in item A was entirely extinguished by the \$100 payment.

98. See *supra* text accompanying note 92.

allocation, or, where no statute exists, should apply an appropriate allocation rule.⁹⁹

The choice of allocation method may depend upon the context of the transaction and upon the desires of the creditor and debtor. The method of separate security agreements for purchase money debt and nonpurchase money debt, although least risky because there is no doubt about what portion of the debt is purchase money, is inefficient and costly. The pro rata method of allocation effectively separates purchase money debt from nonpurchase money debt and steadily decreases the extent to which the creditor maintains purchase money priority, but is unconscionable in the consumer context.

The best method of allocation is FIFO because it enables a creditor to maintain a priority interest in collateral to the extent that the creditor contributed to the purchase price of the collateral, but also enables debtors to extinguish the priority interest in the collateral as quickly as possible. The PMSI is an exception to the UCC's first-in-time, first-in-right rule. Priority arising from a PMSI should be extinguished when the debtor repays the amount obtained from the creditor that enabled the purchase of the collateral because the exception no longer applies. Additionally, FIFO allocation is appropriate in both commercial and consumer settings. The FIFO method of allocation, if applied consistently, fulfills the UCC's goal of promoting uniformity. Creditors will know that their priority as holders of PMSI's will last only until the debtors have repaid the purchase price. As a result, the benefits of PMSI's will be preserved, thereby facilitating secured transactions.

—Lynda Kay Chandler

99. Note, *supra* note 9, at 1176.